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No. 86-44

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

SHEARSON/AMERICAN EXPRESS INC. and
MARY ANN MCNULTY,

Petitioners,

v.

EUGENE MCMAHON, JULIA MCMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

REPLY BRIEF OF PETITIONERS

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ARGUMENT

Respondents rely in their Brief in Opposition on perceived public policy considerations for precluding arbitration of claims asserted under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 *et seq.*, and argue that such disputes cannot be resolved adequately outside the judicial forum due to the unique aspects of federal court litigation and appellate practice. This argument fails to recognize that it is the role of Congress to weigh competing policies when it enacts legislation.

Congress enacted the United States Arbitration Act, 9 U.S.C. § 1 *et seq.*, fully aware of the differences between federal court litigation and arbitration. The Arbitration Act expresses congressional intent to enforce private agreements to arbitrate and to remove from congested courtrooms disputes that can be handled effectively in alternative forums. This Court has often recognized that the Arbitration Act creates a national policy favoring arbitration which is applicable equally to statutory, common law and other disputes. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3355 (1985). Parties to arbitration agreements do not waive substantive rights, but only agree to a change of forum to enforce those rights. They simply contract to forego the judicial forum for the speed and finality of arbitration. The broad congressional policy underlying the Arbitration Act cannot be supplanted by an ad hoc judicial policy approach which effectively allows the judiciary to circumvent the Arbitration Act on a selective basis, and to elevate interests which Congress already has considered and subordinated to the national policy favoring arbitration. Regardless of judicial disagreement with this congressional policy, agreements to arbitrate statutory disputes must be enforced absent clear congressional intent to the contrary expressed in another statute or its legislative history.

The public policy arguments presented by respondents are not only irrelevant, they are misplaced. For example, a large part of the Brief in Opposition deals with current congressional hearings on insider trading abuses. Brief in Opposition ("Opp.") at 21-24, 29-34. These hearings provide no insight into the adequacy of the arbitral forum to resolve federal securities law disputes. Respondents also suggest that the Customer's Agreement they executed which contains an arbitration agreement is an unenforceable contract of adhesion. Opp. at 14 n.8. This issue is not before the Court, and respondents' suggestion is factually and legally inaccurate in any event. Finally, respondents express concern that the viability of the implied private § 10(b) action is somehow undermined by petitioners' contention that Congress could not have intended to prohibit arbitration of this judicially created right of action. Opp. at 16-18. Respondents

do not substantiate their concern, and offer no viable counter-argument to rebut the contention that Congress never intended to prohibit arbitration of claims asserted under § 10(b).

Additionally, respondents erroneously cite three cases for the proposition that this Court has balanced the Arbitration Act against various statutes and, in each case, refused to enforce an arbitration agreement in light of countervailing policy concerns in those statutes. Opp. at 7-8 & n.1 (citing *McDonald v. City of West Branch, Michigan*, 466 U.S. 284 (1984); *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728 (1981); *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974)). None of these cases involved an analysis of the Arbitration Act, however, and each is distinguishable from the present case on other grounds as well.

I. Congress Did Not Intend to Exempt § 10(b) or RICO Claims From the Broad Mandate of The United States Arbitration Act.

The Arbitration Act expresses a strong congressional policy to enforce contractual agreements to arbitrate disputes. This Court often has recognized the broad mandate of the Arbitration Act and its applicability to statutory claims. *See Mitsubishi*, 105 S. Ct. at 3355; *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974). As the Court noted in *Mitsubishi*, the congressional policy favoring arbitration must be enforced by the courts absent contrary congressional intent evidenced in another statute:

> We must assume that if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention will be deducible from text or legislative history.

Mitsubishi, 105 S. Ct. at 3355.

As demonstrated in Petitioners' Brief, there is no indication of any intention by Congress to prohibit arbitration of either

§ 10(b) or RICO claims expressed in either statute or its legislative history. *See* Petitioners' Brief at 14-33, 39-49. As evidence of congressional intent to prohibit arbitration of these claims, respondents and the circuit court below rely on the anti-waiver provision contained in § 29(a) of the Exchange Act, 15 U.S.C. § 78cc(a). That provision is virtually identical to § 14 of the Securities Act, 15 U.S.C. § 77n, which was interpreted by the Court in *Wilko v. Swan*, 346 U.S. 427 (1953), as a congressional prohibition of the enforcement of agreements to arbitrate claims asserted under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2).

The *Wilko* Court interpreted an anti-waiver provision as prohibiting waiver of the judicial forum. This novel interpretation is not supported by the legislative history of either the Securities Act or the Exchange Act, 15 U.S.C. § 78a *et seq.*, and is at variance with the common law interpretation of such a provision as prohibiting waiver of substantive compliance with a statute. *See* Petitioners' Brief at 28-33. The Court's interpretation of an anti-waiver provision was based on its belief that arbitral forums were not capable of enforcing rights under the federal securities laws in 1953. *Wilko*, 346 U.S. at 435-37. This interpretation cannot be justified in light of the fair and efficient arbitral forums which exist today for the resolution of securities disputes, such as those authorized by Congress at the various self-regulatory organizations ("SROs") under the supervision of the Securities and Exchange Commission ("SEC"). *See* Petitioners' Brief at 28-39. The SEC, charged by Congress with the responsibility of interpreting and enforcing the federal securities laws, has reversed its position since *Wilko*, and now agrees with petitioners that securities arbitration at the SROs protects congressionally created statutory rights under the federal securities laws. *See* SEC Brief filed on behalf of petitioners as *amicus curiae*.

Even assuming its continued validity, *Wilko* clearly is limited to the unique and express § 12(2) cause of action, and should not be extended to § 10(b). *See* Petitioners' Brief at 19-28. The § 10(b) right of action was not created by Congress and is judicially implied. Furthermore, respondents brought suit

pursuant to Rule 10b-5, 17 C.F.R. § 240.10b-5, which was promulgated by the SEC under § 10(b) in furtherance of the enforcement and rulemaking powers conferred upon it by Congress. It is thus incorrect to conclude that Congress intended the anti-waiver provision in § 29(a) of the Exchange Act to apply to a right of action it never created, and to exempt it from the clear mandate of the Arbitration Act.

II. Respondents Erroneously Rely on Prior Precedent Of This Court In Arguing That § 10(b) and RICO Claims Are Exempt From The Arbitration Act.

Respondents cite a trilogy of Supreme Court cases in support of their contention that the policies underlying the Arbitration Act should be subordinated in this case. Opp. at 7-8 & n.1 (citing *McDonald v. City of West Branch, Michigan*, 466 U.S. 284 (1984); *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728 (1981); *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974)). The statutes involved in these cases were the Civil Rights Act of 1871, 42 U.S.C. § 1983 (*McDonald*); the Fair Labor Standards Act, 29 U.S.C. § 201 *et seq.* (*Barrentine*); and Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e *et seq.* (*Alexander*). Respondents conclude that:

> This Court has often, in similar circumstances, sought to balance the mandate of the Federal Arbitration Act, 9 U.S.C. Section 1, *et seq.* ("FAA"), against its applicability in certain contexts of remedial, federal statutory legislation, and has in many cases, guided by legislative history and policy concerns, found the FAA inapplicable.

Opp. at 7-8 (footnote omitted).

In fact, none of these cases involved a balancing of the Arbitration Act against another statute. Not only did this Court not balance the underlying policies of the Arbitration Act against the underlying policies of the respective statutes at issue in

McDonald, *Barrentine*, and *Alexander*, the Court did not even mention the Arbitration Act in its analysis, as it was not in issue in any of these cases. All three cases dealt with the preclusive effect of a prior arbitration commenced pursuant to an arbitration clause contained in a collective bargaining agreement on a subsequent federal statutory action brought by an individual. *See McDonald*, 466 U.S. at 285-87; *Barrentine*, 450 U.S. at 729-30; *Alexander*, 415 U.S. at 38.[1] The Court in each case held that the prior arbitration proceeding did not preclude the subsequent federal action. Since the arbitration agreements in these cases specifically limited the power of the arbitrator to resolve contractual issues, the arbitrator was precluded from addressing statutory issues. Any award which addressed statutory issues would be subject to avoidance because the arbitrator exceeded his authority. *See McDonald*, 466 U.S. at 290-91; *Barrentine*, 450 U.S. at 744; *Alexander*, 415 U.S. at 53. In addition, the arbitration agreements involved in each case were negotiated by a union which did not necessarily represent the interests of the individual. *See McDonald*, 466 U.S. at 291; *Barrentine*, 450 U.S. at 742; *Alexander*, 415 U.S. at 51.

These issue preclusion cases are clearly distinguishable from the present case involving an arbitration agreement which does not restrict the arbitrator's authority and which was executed by individuals. Securities arbitrators, many of whom are attorneys, are empowered by the agreement executed by respondents to address all issues raised by the parties, statutory or otherwise, and are well-equipped to carry out the remedial purposes of the federal securities laws through the arbitral process. *See* Petitioners' Brief at 33-39; *see also Amici* Briefs filed by the SEC, the Securities Industry

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[1] In all three instances, the Court found two separate and distinct claims. One claim was based on a collective bargaining agreement, and the other claim was based on a statute. *See McDonald*, 466 U.S. at 288-90; *Barrentine*, 450 U.S. at 737-38, 745-46; *Alexander*, 415 U.S. at 48-51.

Association, Inc. ("SIA") and the American Arbitration Association ("AAA").[2]

III. The Public Policy Arguments of Respondents Are Irrelevant and Misplaced.

A. The Implied § 10(b) Right of Action Is Not Undermined by Acknowledging That Congress Did Not Intend to Prohibit Arbitration of Such A Claim.

Congress could not have intended the anti-waiver provision in § 29(a) of the Exchange Act to prohibit waiver of the judicial forum for the resolution of § 10(b) disputes since Congress did not create, or even consider creating, a private § 10(b) action. The § 10(b) right of action was judicially created by implication. *See* Petitioners' Brief at 24-26. Respondents label this argument as "superficial," yet offer no viable counterargument. *See* Opp. at 13. Rather, respondents reiterate at length that the existence of the implied § 10(b) action has been consistently recognized by this Court and is beyond doubt. Petitioners do not dispute this point. Respondents also suggest that petitioners' argument somehow undermines the § 10(b) action by the mere fact that it distinguishes § 10(b) from express causes of action under the federal securities laws. Opp. at 17-18. This, of course, is not the case. Petitioners' argument is advanced only in the context of examining congressional intent with respect to the arbitrability of an implied right of action. While the

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[2] Clearly the courts do not share respondents' concerns about the competency of arbitrators. Of the three courts of appeals that purported to rule on the arbitrability of § 10(b) claims free from the restraint of binding prior precedent since this Court's decision in *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213 (1985), two ruled that claims asserted under § 10(b) are arbitrable. *See Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 806 F.2d 291 (1st Cir. 1986); *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393 (8th Cir. 1986). *But see Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986). However, even the *Conover* court did not base its decision on any supposed lack of competency on the part of securities arbitrators.

regulatory scheme of Congress permeates the federal securities laws, it simply cannot be argued that Congress ever intended to prohibit arbitration of an action it did not create. The undisputed fact is that Congress did not intend to create either judicial remedies or a judicial forum for judicially implied rights of action.

The contention that an anti-waiver provision cannot be construed to prohibit arbitration of the implied § 10(b) right of action has been adopted recently by the Court of Appeals for the First Circuit which ruled that agreements to arbitrate § 10(b) claims are enforceable:

> Because of the absence of any express "provision" for a judicial forum under [§ 10(b) of] the 1934 Act, we conclude that the 1934 Act's anti-waiver clause, by itself, does not suffice to indicate a Congressional intent to preclude arbitration.

Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 806 F.2d 291, 296 (1st Cir. 1986); *see also* Fletcher, *Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements*, 71 Minn. L. Rev. 393, 402-04, 436-38 (1987). The distinction between an express and an implied cause of action is substantive when analyzing congressional intent. A Justice White articulated:

> *Wilko*'s solicitude for the federal cause of action—the "special right" established by Congress—is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action.

Byrd, 470 U.S. at 225 (White, J. concurring) (citation omitted). There is no reason to ignore this analysis due to unfounded concerns that an implied right of action will be undermined.

B. Congressional Hearings on Insider Trading Have No Bearing on the Adequacy of the Arbitral Forum.

The adequacy of the arbitral forum to resolve securities disputes has been developed fully by petitioners in their Brief and by the Briefs filed by the SEC, the SIA and the AAA, as *amici curiae*, in support of petitioners.[3] Nonetheless, respondents question the ability of the SEC to oversee SRO arbitration adequately, pursuant to the mandate given the SEC by Congress in 1975. The concerns of respondents are premised on the current congressional investigation concerning market abuses such as stock manipulation and insider trading. *See Insider Trading in the Securities Markets, Hearings Before the H.R. Subcomm. on Oversight and Investigations of the H.R. Comm. on Energy and Commerce*, 99th Cong., 2d Sess. (1986). This congressional investigation does not concern the arbitration procedures at the various SROs:

> The hearing today is about just the kind of events which can destroy public trust and confidence. The questions we raise today about *insider trading* and *stock manipulation* will logically lead the Subcommittee in the coming year to look at corporate takeovers, leveraged buyouts, and the proper role of arbitrageurs.

Opp. at 21. (citing Opening Statement of Hon. John D. Dingell) (emphasis added).[4] Respondents' attempt to characterize

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[3] *See* Petitioners' Brief at 33-39, 46; SEC *Amicus Curiae* Brief at 13-21 (limited to § 10(b) claims); SIA *Amici Curiae* Brief at 5-11; AAA *Amicus Curiae* Brief at 12-19.

[4] Conspicuously absent from respondents' extensive quotations of the Opening Statement of the Chairman of the Subcommittee on Oversight and Investigations, is his praise of the SEC's recent oversight enforcement in this area. The Chairman stated: "On behalf of the Subcommittee, I want to applaud the efforts of the SEC enforcement staff in putting the Levine and Boesky [insider trading] cases together. They have worked long and hard, and justly deserve credit." *Insider Trading in the Securities Markets, Hearings before the H.R. Subcomm. on Oversight and Investigations of the H.R. Comm. on Energy and Commerce*, 99th Cong., 2d Sess. (1986) (Opening Statement of Hon. John D. Dingell).

congressional inquiries into insider trading and market manipulation as casting doubt over "[t]he adequacy of the arbitral forum to vindicate [statutory] rights" cannot be substantiated. *See* Opp. at 5.[5]

In the final analysis, the issue is not whether the SEC oversees SRO arbitration since nothing in the Arbitration Act requires such oversight. The AAA, like the SROs, also provides a fair and efficient forum for the resolution of securities disputes notwithstanding the absence of SEC jurisdiction. *See* AAA *Amicus Curiae* Brief submitted on behalf of petitioners. The issue remains whether Congress intended to allow federal securities law claims to be heard in an arbitral forum and whether securities arbitration is competent, efficient and impartial. Respondents offer no compelling evidence to challenge the competency, efficiency or fairness of securities arbitration in the United States.[6]

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[5] *See also* Opp. at 29-34. Without supporting authority, respondents imply that any deficiency of SEC oversight in this area applies to SRO arbitration. As more fully discussed in Petitioners' Brief and the *amici* briefs filed in support of petitioners, the SEC has found the Uniform Code of Arbitration, which governs SRO arbitration, "to be in the public interest and in furtherance of just and equitable principles of trade." Additionally, the SEC retains jurisdiction to correct perceived abuses or unfairness in the Arbitration Rules and is required to approve and has approved any SRO rule changes since 1975. *See* Petitioners' Brief at 33-39. There is simply no evidence that SEC oversight is lacking in the area of SRO arbitration.

[6] Respondents suggest to this Court in their Brief in Opposition that Shearson has claimed in another pending action that SRO arbitration is inherently unfair. Opp. at 25-26. This gross mischaracterization was rejected recently by the Magistrate who recognized that Shearson opposes arbitration in that case because plaintiffs were not customers of Shearson, and had no arbitration agreement with Shearson. Furthermore, the disputed transactions involved private notes not purchased or sold through Shearson on any securities exchange. The Magistrate found that "*McMahon* is entirely distinguishable." *See Shearson Lehman Brothers, Inc. v. Lamers*, No. B-86-507 (TFGD), Recommended Ruling on Motion to Dismiss (D. Conn. Jan. 20, 1987) at n.6.

C. The Contractual Agreement of the Parties to Arbitrate Their Disputes Is Valid and Should Be Enforced.

While respondents concede that they executed the arbitration agreement voluntarily, they nonetheless suggest, without foundation, that the agreement is contained in an unenforceable contract of adhesion. Opp. at 14 n.8. The district court dismissed this argument as "wholly unconvincing" and held that respondents failed to set forth any facts which demonstrated fraud or duress by petitioners or lack of bargaining power on the part of respondents.[7] Respondents never alleged that they attempted to negotiate the agreement in any way. The Court should not review this factual determination by the district court especially in light of respondents' failure to raise the contract of adhesion issue before the court of appeals, which found "no reason to disturb the district court's threshold [factual] determination that an enforceable arbitration clause was in effect." *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 96 n.6 (2d Cir. 1986).

Nonetheless, it should be noted that a customer does not have to sign an arbitration agreement to engage in securities transactions. A recent survey of four of the largest national brokerage firms reveals that customers can open a cash account at three of these firms without entering into an arbitration agreement. Although margin agreements are required at all four firms, only two of these agreements contain arbitration clauses. *See* Fletcher, *Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements*, 71 Minn. L. Rev. at 445-48. Since a customer does have bargaining power, an arbitration agreement contained in a Customer's Agreement is not an adhesion contract.

In addition, even an adhesion contract will be enforced unless its terms are unduly oppressive, unconscionable or against public

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[7] *See McMahon v. Shearson/American Express, Inc.*, 618 F. Supp. 384, 386 (S.D.N.Y. 1985) ("Arbitration clauses are routinely upheld by the courts, and, given [respondents'] sizeable investment, there is nothing to indicate that they were without bargaining power."), *aff'd in part, rev'd in part on other grounds*, 788 F.2d 94 (2d Cir. 1986).

policy. *See Ilan v. Shearson/American Express, Inc.*, 632 F. Supp. 886, 891 (S.D.N.Y. 1985); *Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505, 1511-12 (S.D.N.Y. 1985). An arbitration agreement contained in a Customer's Agreement cannot be characterized as unconscionable or contrary to public policy since there exists a strong national policy favoring arbitration. *See Mitsubishi*, 105 S. Ct. at 3353-54; *Finkle & Ross*, 622 F. Supp. at 1512; *Ilan*, 632 F. Supp. at 891; *see also Coleman v. Prudential Bache Securities, Inc.*, 802 F.2d 1350, 1352 (11th Cir. 1986) ("there is nothing inherently unfair or oppressive about arbitration clauses").

CONCLUSION

Based on the reasons contained in Petitioners' Reply Brief, as well as those in their Brief on the merits, the judgment of the United States Court of Appeals for the Second Circuit should be reversed insofar as it refused to enforce the contractual agreement of the parties to arbitrate claims asserted under § 10(b) of the Exchange Act and RICO.

Dated: New York, New York
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Respectfully submitted,

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